THE ECONOMIC OUTLOOK:
Partly Cloudy and Cooler

Remarks of
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to the
Alabama Cement Industries Association
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The nation is now well into the second year of what has turned out to be a strong recovery from the 1981-82 recession. While I believe the recovery will continue, I also believe this is a good time to borrow a phrase from the meteorologists who try to keep us prepared for what the weather will do to tomorrow's picnic:

I would say that the economic outlook is partly cloudy and cooler.

The clouds I refer to are the huge federal deficits that loom in seemingly unbroken procession as far as the eye can see. A number of factors, including the recent interest-rate increases, already are cooling the rather torrid economic growth of the first

Don — 6/7
This reflects Sheila's comments.
RPF has a copy.
And the Print Shop has been asked to deliver the usual 140% "blow-up" to him by 2 p.m. Friday.
It has been a busy day!
Diane

quarter of this year. The question remains as to whether this cooling will be sufficient to accommodate enlarged demands by the federal government. There might even be a chance of thundershowers in the form of resurgent inflation later in the decade, if we don't resolutely protect the gains we have made against that menace. That's an important point for you who are in the construction industry; if long-term rates are higher in anticipation of these problems, that could have ominous implications for your business outlook.

A few other clouds hover on the national horizon, all of them potentially troublesome. We are plagued, for instance, with lagging international trade and energy sectors. We are troubled by the woes of heavily indebted less-developed countries, whose burdens carry far-reaching implications for the global economy. And we still wrestle with an unemployment level that, while improving, remains unacceptably high, especially in some hard-hit areas, such as northwest Alabama.

But most disturbing of all are the dark deficit clouds that seem to aggravate so many of our other problems.

I'll address those questions shortly. But first, let's take a look at our prospects for 1984, starting with the national economy.

The National Economic Scene

The year 1983, obviously, was an encouraging one. The nation's economy grew at nearly 7.5 percent in the last nine months of 1983 — a very respectable rate of increase for a recovery. The recent revised report from the Commerce Department indicates a growth rate of just under 9 percent for the first quarter of 1984 — more rapid than many observers had predicted; however, a significant portion of that growth rate is attributed to increased inventory accumulation. Fortunately, this does not suggest a build-up of inflationary pressures, as would be the case if real GNP growth were going directly into personal consumption. It now seems increasingly likely — although not certain — that the growth rate

will moderate, easing downward toward a safer and more sustainable rate.

As 1984 began, the ringing of cash registers was one of the most obvious signs of continued economic vigor. Retail sales have been brisk over the first four months of this year, suggesting that the recovery still retained a lot of momentum through April. What's more, consumers have been putting their money down on big-ticket items such as automobiles and homes. Seasonally adjusted consumer credit expanded by $5.9 billion in March, equalling the December increase, with its Christmas buying spree. While month-to-month vari;ation has occurred, auto sales have remained strong; in May, cars were selling at an annual rate of about 11 million units.

Though mortgage rates recently have been reflecting some upward pressure, builders remain cautiously optimistic about prospects for the rest of the year. Bouts of severe weather caused sharp monthly fludtuations in housing starts. In May, starts were running just under 2 million, the strength being more in multifamily

than in single family homes. Home sales have, in fact, been a little weak, declining in three of the past four months.

The public's continuing optimism, although possibly somewhat less exuberant than at the start of the year, suggests continuing demand for manufactured goods. Idle plants across the country have been reopening and, predictably, industrial output has been gaining strength for months. Business equipment production and investment in structures have been leading the way as liberalized depreciation and tax credit rules stimulated these areas.

With more people returning to their jobs, our worrisome unemployment picture has improved. Total employment, which had remained nearly flat throughout 1982, began to move up briskly as the recovery gathered momentum in mid-1983. More than 2 million new jobs have been added since the start of 1984. The civilian jobless rate fell to 7.5 percent in April. The fact that more workers are taking paychecks home helps to explain both the retail spending activity and the renewed national confidence that it reflects. In

fact, real disposable personal income — after adjustment for both inflation and seasonal factors — has been increasing, giving consumers a solid gain in purchasing power.

Corporate profits rose by one-third over the second and third quarters of 1983 and were also strong in the fourth quarter, despite a slight dip. Growth in profits resumed its upward trend in the first quarter of 1984. The overall increase has had a profound effect in generating new business investment. The "big three" automakers reported excellent profits for 1983, and then topped that with a record $3.2 billion profit for the first quarter of 1984. They're not expecting to challenge that record anytime soon, but they do look for a solid profit performance throughout the remainder of the year. Business inventories and new factory orders are both gaining. Business inventories have been rising but, by past standards, they do not seem excessive relative to current sales. And the Commerce Department's Index of Leading Indicators, which monitors our overall economic health, has increased in 19 of the past 20 months.

So much for the recent past. What's ahead for the national economy in the remainder of 1984? More of the same, I believe, except that we can look for a more moderate growth rate. Moderation is inevitable and is necessary to help us make the transition to a sustainable expansion. A realistic growth projection for the full year 1984 seems to be something in the neighborhood of 4 to 5 percent. That is still well above the long-term trend rate of around 3 to 3.5 percent.

Perhaps you are wondering what is slowing the economy. Consumer spending may decelerate as "catch-up" demands are satisfied. The continued strength of the dollar on foreign exchange markets tends to depress exports and increase demand for imported goods. In addition, the recent increases in interest rates should take the edge off the demand for items normally financed — provided that inflationary expectations do not rise, making it seem desirable to buy now, despite high interest rates, rather than to buy later at higher prices and even higher interest rates.

Prices seem likely to behave quite respectably over the rest of the year, although they could rise a bit more than they did in 1983. This pattern is normal as a recovery matures. Inflation, which averaged a frightening 13.5 percent in 1980 (as measured by the consumer price index) dropped to just 3.2 percent last year. Even the most pessimistic economic prophets expect consumer prices to rise little more than 6 percent in 1984 on a fourth-quarter-to-fourth-quarter basis, while the more optimistic predict an inflation rate of 5 percent or below.

The Southeastern Recovery

Turning now to the regional economy, we find the Southeast, as a whole, entering a new stage of the recovery. While the entire region faces rather bright prospects for the remainder of 1984, some areas — including parts of Alabama — have not yet begun to share fully in the recovery.

The Southeast, like the nation, began a strong upturn in the first half of 1983. The revival in residential construction that

became evident late in 1982 stimulated the construction-related industries in many parts of the Southeast. As unmistakable signs of recovery encouraged consumers to resume spending, sales of autos, home furnishings, and textiles grew briskly.

Now, as we near the end of the second quarter of 1984, the recovery is rolling along at a comfortable clip in most areas. Unemployment is declining, although the Southeastern states hardest hit by the recession — Alabama, Louisiana and Mississippi — were still suffering from jobless rates in the 10-12 percent range until quite recently. The average rate for the region had dropped to about 7.? percent by last month.

Although today's higher interest rates could take some steam out of the housing market, the near-term outlook throughout most of the Southeast is for continued strength. Therefore, our area's mills and other light industries that feed carpets, upholstery fabrics, furniture, lumber, and similar items to the nation's homebuilders and buyers should enjoy a profitable year. For the longer term,

the national prospect for housing, textiles and apparel generally is favorable; the baby-boom generation has entered the 25-to-45 age group known to be big spenders on housing, home furnishings, and apparel.

With the recession behind us, our manufacturers' greatest challenge is posed by foreign competition, particularly in textiles and apparel. More than 14 percent of the U.S. textile market now is supplied through imports. Yet a continuation of the national economic recovery through 1984 should set many sectors of our regional economy to humming. The airline, tourism, and convention businesses, all important to the Southeast, should grow sharply as conventioneers and vacationers flow to our region's many tourist attractions.

Our economists see cause for optimism even on the part of our region's troubled agribusiness sector. A severe drought across most of the Southeast in 1983, as you know, left our farmers hard pressed to repay the debts they had accumulated over several years

of adversity extending back to 1977. For the survivors, however, the outlook is brighter for the remainder of 1984. Since crops were short in 1983, most farmers have resumed full-scale planting — at least, those who could still get the credit they need to buy seed, fertilizer, and tractor fuel seem to be doing so.

Throughout the Southeast, the outlook for electronic technology is especially bright. Electronic components are key ingredients in the burgeoning information age, and the Southeast should increase its share of high-tech industry because of its economic vitality and locational advantages. Alabama's high-tech industry, of course, centers around Huntsville and Birmingham, where conditions have fostered the mix of technology and engineering know-how that spawns new businesses.

The Sunbelt is continuing to attract migrants from other parts of the nation. That's a source of profits for the Southeast's forest-products industry, which supplies about 30 percent of the nation's lumber. All elements of the Southeast's construction industry should

do well as they provide housing for the streams of new residents drawn by our area's temperate climate and economic opportunities.

The return of healthy economic growth in European, Canadian, and Japanese economies will be another source of strength for our region's forest-products industry. It should also benefit mining and agriculture. Southeastern exports of paper, coal, chemicals, fertilizers, and farm products seem likely to grow at above-average rates in coming months.

Alabama's Construction Industry

While the outlook for the Southeast as a whole is bright, the economic sunshine will be brighter in some areas than in others. As you might guess, it will shine most brightly in Florida, with Georgia running a close second. Unfortunately, Alabama — which was among the southeastern states hardest hit by the recession — seems unlikely to be among the biggest gainers in the recovery. Nevertheless, it should make some good progress over the next several months.

Alabama's residential construction industry grew faster in 1983 than in any year since 1970. That growth tapered off considerably in the first quarter of this year, but remains on a par with 1978, the most recent good year for the state's homebuilders. The recent slowdown in the growth numbers can be traced to the fact that, since most Alabamians who postponed their home buying or building plans during the recent recession went ahead with their plans last year, a large part of the pent-up demand has now been satisfied. As a result, this year we would expect home sales to grow at the rate of new family formation plus an increment to allow for in-migration. Since Alabama's economy has not yet gained enough strength to offer an abundance of job opportunities, in-migration is unlikely to be heavy.

If interest rates continue their present climb, further slowing of the rate of homebuilding and buying would be a logical consequence. However, the widespread use of adjustable rate mortgages should cusion the decline.

As you are probably aware, the ability of financial institutions to continue to finance housing through ARMs has come into question. Senior management people at southeastern savings and loan associations tell us that this issue has implications for the continued health of the entire residential construction sector. Analyst have begun to wonder whether homebuyers nationwide will be able to keep on making their payments if rising interest rates trigger escalations in their monthly payments. ARMs account for 60 percent of home mortgages currently made by Alabama thrift institutions. Of these ARMs, less than 1 percent are sold by the originating institutions, compared to an average of 25 percent for thrifts in the Southeast as a whole. If many Alabama home buyers find themselves unable to make the payments on the ARMs, Alabama thrifts may find it difficult to carry on their role as primary suppliers of capital for the residential construction industry. Residential construction, of course, contributes importantly to the demand for concrete in Alabama.

For the state's commercial construction sector, 1983 was the best year since 1973. Just as for residential housing, much of the demand for commercial building was accumulated during the recession and satisfied last year. The ongoing resurgence of employment and homebuilding has encouraged construction of shopping malls and other retail space, particularly in Birmingham. But high interest rates and the generally slow growth of Alabama's economy should hold back commercial construction in the state in coming months. Developers report that they are forced to resort to creative financing to make a profit on commercial construction at today's interest rates.

Overall, we expect 1984 will turn out to be a rather slow year for commercial construction in Alabama, unless interest rates begin to decline after mid-year.

That's a thumbnail description of the outlook, as I see it. The Southeast's economy, which has done its share of sputtering since 1980, is running more smoothly in most areas. All in all, the

economic picture is quite encouraging. Yet, somehow, a good many of us find ourselves dissatisfied with it. Good as it is, we know it could be better. And we wonder what is holding us back.

Clouds on the Horizon

Clearly, the nation's economy retains some worrisome trouble spots. The international trade and energy sectors, which slumped in the 1981-1982 recession, remain somewhat sluggish even now. A strong dollar and world recession cut into international trade flows throughout most of 1983, including the flow of agricultural and energy products at most ports of our region. If our nation's widening merchandise trade deficit helps to increase the value of key foreign currencies in terms of our dollar, the export of America's manufactured goods should grow. That would supplement the increased trade flow arising from economic growth elsewhere around the world. The economic recovery should help to stimulate the volume of crucial exports, such as coal, phosphate, pulp and paper, and chemicals. It should also increase imports of oil and machinery into the United States.

Another global problem that could cause us trouble locally is the plight of heavily indebted less-developed countries — the so-called "LDCs" that have been so much in the news recently. The recent increases in interest rates have added to the pressure they feel. The list of nations hard-pressed to pay their national bills is a long one — including nations such as Brazil, Mexico, and Argentina in our own hemisphere and Poland half a world away. They may be remote in terms of miles, but their financial crises carry momentous significance to us in both political and financial terms.

What about other clouds that don't seem to have silver linings?

Lingering unemployment is one of those problems. We can take comfort in the fact that its level recently dropped again and is well below the peak that it reached not too long ago. But our 7.5 percent national rate for civilians represents around 9 million workers out of jobs — and those unemployed workers are concentrated in a few areas that have not yet begun to share fully in the recovery.

Many consider interest rates to be another major problem. Real interest rates appear high by past standards, though it is difficult to gauge the inflationary expectations against which long-term rates should be measured. Moreover, financial deregulation — which means that bank deposits now pay relatively higher rates than in the past — provides some offset to interest costs.

I noted earlier our nation's progress against inflation. We in the Federal Reserve take pride in our contribution to that progress. I believe that it demonstrates the importance of an independent central bank that can take appropriate monetary action without regard to short-run political considerations. The fight against inflation has been painful for many, yet it must be continued to prevent a return of the dangerous erosion of our money that we saw in the 1970s.

That war has not yet been won. Many in the marketplace are skeptical about the long run. They question our willingness as a nation to keep a rein on wage settlements and price hikes, and they

question the determination of the Federal Reserve to stick by its guns. But I can assure you that we will continue to fight inflation with vigor. We will not surrender the gains that have been won at such considerable cost and pain to many in our society.

But, if our monetary policy is to remain resolute, what about the other side of the coin? What about fiscal policy? Can the federal government regain control of our budget and its persistent deficits? Monetary and fiscal policy must operate hand in hand if we are to achieve our goal of smooth economic growth. You simply cannot drive for long with one foot on the brake and the other on the accelerator.

Do Deficits Matter?

One of the debates in contemporary economics centers around the question of whether federal budget deficits matter. I am convinced that repeated deficits in the hundreds of billions of dollars do, indeed, matter. They represent the most ominous clouds on the economic horizon. While growth in government expenditures

provides an appropriate push for a weak economy, this stimulus needs to be reduced — or even eliminated — as the economy approaches full utilization of its resources.

When the federal government must borrow so heavily from the limited pool of credit that must also meet the needs of business people like yourselves, it has important implications for the economy. It affects the ability of businesses and consumers to obtain the credit they need — at an interest rate they can afford. Repeated large deficits inevitably bloat the national debt, and the cost of debt service swells along with it; it is sobering to consider that interest on the national debt is already running at more than $100 billion a year — an amount equal to more than half of the projected deficit for the current fiscal year.

If we truly want our federal government to be as large as those projected deficits suggest, then perhaps we should bite the bullet and support efforts to increase taxes sufficiently to balance the budget. On the other hand, if we truly want to reduce the

government's size, then we must face the difficult and politically painful decisions relating to deep cuts in social and defense spending. Either tax increases or spending cuts would help. If neither is forthcoming, then we need to slow the growth of the private economy. And we will have to accept that slower growth as the price of that decision. If we seek the rapid and simultaneous growth of both the public and private sectors, the price of that decision would be inflation — possibly more damaging than we have seen before.

In the long run, then, if we prefer not to stifle the growth of the private sector, the solution to the deficit problem must come through better control of federal spending. We must learn to prevent problems, not try to spend ourselves out of them. To gain that kind of control, we must develop realistic national priorities and the political courage to stick by them. Instead of heeding the countless special interest groups clamoring for increased federal spending, our representatives must be sensitive to the long-term interests of the entire nation. They must remember always to ask

this essential question when considering an appropriation: Can we afford it? Too often, the only question seriously considered has been: Do we want it? We simply cannot continue to promise our people increased social spending, increased defense spending, low inflation, low interest rates, full employment — and low taxes at the same time.

But Congress does not deserve the full blame for this overspending. Our legislators reflect the pressures directed at them by their constituents. The solution must come, at least in part, in the form of public education that cultivates a broad understanding of basic economic realities.

In our commendable zeal to improve the equity with which we divide our national wealth, we may have devoted inadequate attention to those who produce it. Until quite recently, when it was spurred by the recession, our nation's productivity has improved more slowly than that of some competitors in the world marketplace. We must keep before us the fact that it is economic growth that

provides the resources we must have if we are to address our social problems.

Let me conclude by saying that my optimism about our nation and our region transcends the good economic news of 1983 and 1984. To be sure, if history is any guide, we will have low as well as high points in the years ahead. However, we have recently survived a serious recession with our political and business institutions not only intact, but perhaps even stronger than before. Equally important, we weathered the storm with less social unrest than we might have expected a few years ago.

I am convinced that our nation's ability to emerge from that recent ordeal in such good shape is due in no small measure to the strong will of the American people. It demonstrated once again our ability to rise above adversity and to continue with rugged determination to achieve a quality of life made rich not just by material goods but by justice and spiritual values as well.

That is why I am further convinced that our great nation will continue in its historic role as the leader of the Free World. And that essentially is why I remain constantly optimistic about our destiny.

My forecast is for partly cloudy economic skies — not for dark and lowering storm clouds — and a cooler pace of economic growth — not a return to the wintry conditions of the recent recession. With some prudent, far-sighted action on the part of the administration and Congress to trim the federal budget, these deficit clouds might be dispelled. Then, I think, we could look forward to the kind of sunny, warm economic climate that would foster an extended period of healthy growth for Alabama, the Southeast, and the nation.

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